**Before the**
**Federal Communications Commission**
**Washington, D.C. 20554**

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| In the Matter of | ) | |
| | ) | |
| Unbundled Access to Network Elements | ) | WC Docket No. 04-313 |
| | ) | |
| Review of the Section 251 Unbundling | ) | CC Docket No. 01-338 |
| Obligations of Incumbent Local Exchange | ) | |
| Carriers | ) | |

# COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES ON NOTICE OF PROPOSED RULEMAKING

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# COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES ON NOTICE OF PROPOSED RULEMAKING

## SUMMARY

The Commission's main goal in this proceeding should be to produce rules on unbundling -- and a process to carry out those rules -- that will follow the language and intent of the Telecommunications Act. Such rules will withstand challenge in any court that gives proper deference to the Commission's decisions in interpreting impairment, as is required to determine which network elements are to be unbundled under the Act.

In these comments, NASUCA proposes to the Commission a framework for rules that will promote competition for residential and small business customers, consistent with the Act. Therefore, the comments focus on local switching, a key component of the unbundled network element platform, which is the means by which much of the current competition for residential and small business customers has arisen.

NASUCA's proposal is based on a detailed review of the statute, the Supreme Court's decisions, and -- given the lesser weight given to the decisions of lower courts -- to a lesser

extent, the decisions of the D.C. Circuit Court of Appeals. NASUCA also salvages as much as possible of the Commission's *Triennial Review Order*, in order to avoid reinventing the wheel, a particularly wasteful task given the pressures on the Commission for a timely order.

In the *Triennial Review Order*, the Commission made a national finding of impairment for unbundled local switching, and then delegated to the states the responsibility to make decisions on impairment based on standards created by the Commission. The D.C. Circuit in *USTA II* overruled that "subdelegation." The Commission should adopt as its own standards most of the impairment standards it previously imposed on the states and should make decisions based on those standards, and should delegate fact-finding to the states.

The record in the Triennial Review proceeding was sufficient to at least create a presumption that, in serving the mass market -- residential and small business customers -- competitors were impaired without access to the incumbents' unbundled local switching. In many areas of the country, incumbents did not challenge the Commission's national finding of impairment for mass market local switching. In those areas, impairment should be presumed. In other areas, the Commission will have to utilize and supplement the records developed in the state proceedings.

With regard to local switching, the Commission took to heart the *USTA I* court's direction to adopt a more nuanced approach, with one exception: The Commission divided switching into two product markets, enterprise and mass market. The correct approach would be to subdivide the mass market into its proper customer classes: residential and small business.

The Commission then required the states to define geographic markets. After refining its geographic market principles somewhat, the Commission should use the factual records from the

states to delineate markets within each state where impairment for residential and small business switching will be tested.

In the Commission-ordered state proceedings, the states were to examine impairment in each geographic market in a two-stage review. The first stage required the states to find no impairment in geographic markets where competitors serving the mass market were using their own switches, or were purchasing switching from other sources. In those areas, the incumbents would not have to unbundle their switches. The Commission should adopt the same standards, although separately for residential and small business service, and should review the state records based on those same standards.

The second stage of the state proceeding required the states to find no impairment if it could be shown that, despite the lack of actual deployment, it was nonetheless economic for a competitor to operate in a geographic market. The Commission should adopt that standard, but should define the test for "economic" as considering entry by a hypothetical CLEC that uses the most efficient telecommunications technology currently available, a standard previously upheld by the Supreme Court. Again, the analysis should be separate for residential and for small business service.

If the records from the states are insufficient for the Commission to make judgments on mass market switching, then the Commission will have to either place further fact-finding responsibilities on the states, or will have to engage in that targeted fact-finding on its own initiative. In the meantime, the Commission should continue the interim rules. In the meantime, unbundling should continue.

## I. INTRODUCTION

On August 20, 2004, the Federal Communications Commission ("Commission") issued a Notice of Proposed Rulemaking ("NPRM")[1] that solicited comment on alternative unbundling rules to implement the obligations of section 251(c)(3) of the Communications Act of 1934, as amended,[2] in a manner consistent with the decision of the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") in *USTA II*.[3] The National Association of State Utility Consumer Advocates ("NASUCA")[4] hereby submits such comments.

The Commission's Interim Order accompanying the NPRM also "set forth a comprehensive twelve-month plan … to stabilize the market."[5] For the first six months, the Commission required incumbent local exchange carriers ("ILECs") to continue providing

[1] FCC 04-179 (rel. August 20, 2004). Along with the NPRM, the Commission issued an interim order, as discussed below. The order and NPRM were published in the Federal Register on September 13, 2004 at 69 Fed. Reg. 55111.

[2] We refer to the Communications Act of 1934, as amended, *inter alia*, by the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, as the "1996 Act" or the "Act." See generally 47 U.S.C. § 151 *et seq*.

[3] *United States Telecom Ass'n v. FCC,* 359 F.3d 554 (D.C. Cir. 2004) ("*USTA II*"). *USTA II* overturned the Commission's decision *In the Matter of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338; *In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98; *In the Matter of Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 98-147, Report and Order and Order on Remand, 18 FCC Rcd 16978 (2003) ("*Triennial Review Order*").

[4] NASUCA is a voluntary, national association of 44 consumer advocates in 42 states and the District of Columbia, organized in 1979. NASUCA's members are designated by the laws of their respective states to represent the interests of utility consumers before state and federal regulators and in the courts. See, e.g., Ohio Rev. Code Chapter 4911; 71 Pa. Cons. Stat. Ann. § 309-4(a); Md. Pub. Util. Code Ann. § 2-205(b); Minn. Stat. Ann. Subdiv. 6; D.C. Code Ann. § 34-804(d). Members operate independently from state utility commissions, as advocates primarily for residential ratepayers. Some NASUCA member offices are separately established advocate organizations while others are divisions of larger state agencies (*e.g.*, the state Attorney General's office). Associate and affiliate NASUCA members also serve utility consumers, but have not been created by state law or do not have statewide authority.

[5] FCC 04-179, ¶ 1.

unbundled access to switching, enterprise market loops, and dedicated transport under the same rates, terms and conditions that applied under their interconnection agreements as of June 15, 2004.[6] For the six months thereafter, in the absence of a Commission holding that particular network elements are subject to the unbundling regime, the same elements would be made available to serve existing customers, at increased rates.[7]

The United States Telecom Association ("USTA"), Qwest Communications International, Inc. ("Qwest") and the Verizon telephone companies ("Verizon") have sought a writ of mandamus from the D.C. Circuit, seeking to invalidate these interim provisions.[8] These companies have also appealed the interim rules. USTA and the two Regional Bell Operating Companies ("RBOCs") assert that the interim Order is contrary to *USTA II*.[9] NASUCA's comments here, however, do not turn on the validity of the interim Order. Rather, these comments focus on the fundamentals of the law on unbundling, which, in turn, depend on the definition of impairment in § 251(c).

In the interim, nonetheless, the question still remains: What happens until the Commission makes its "final" determinations on unbundling rules? One alternative, supported by the RBOCs and USTA, is that until the Commission makes a determination on impairment

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[6] Id. "These rates, terms, and conditions will remain in place until the earlier of the effective date of final unbundling rules promulgated by the Commission or six months after Federal Register publication of this Order, except to the extent that they are or have been superseded by (1) voluntarily negotiated agreements, (2) an intervening Commission order affecting specific unbundling obligations (*e.g.*, an order addressing a pending petition for reconsideration), or (3) (with respect to rates only) a state public utility commission order raising the rates for network elements." Id.

[7] Id. Contrary to the specific language of the Order (see id., ¶ 29), Chairman Powell asserts that there are no automatic increases after six months. Id., Statement of Chairman Michael K. Powell at 1.

[8] *United States Telecom Ass'n v. FCC*, D.C. Cir. Docket 00-1012, Order (September 1, 2004).

[9] It is clear that a main source of the Commission's predicament here is the failure of the Commission, the Solicitor General, and the Administration to appeal *USTA II* to the Supreme Court.

following the third remand, there is no unbundling obligation. This means that the provision of ILEC network facilities becomes an entirely voluntary act on the part of the ILECs, which can charge whatever the traffic may bear for the use of those facilities. This puts the millions of customers nationwide receiving service through TELRIC-priced[10] unbundled network elements ("UNEs") at risk of substantial price increases, or indeed loss of service if competitive local exchange carrier ("CLEC") cannot pay the incumbents' price for network elements. In that event, the consumers will have to go without service or will be forcibly migrated back to the ILECs.[11] NASUCA submits that such a result would be contrary to the spirit of the 1996 Act.[12]

*USTA II* left little of the key provisions of the *Triennial Review Order* intact. As emphasized in these comments, the *USTA II* court, *inter alia*, vacated the Commission's delegation of authority to state commissions to make determinations on unbundling,[13] and vacated and remanded the Commission's nationwide impairment findings for mass market switching and dedicated transport.[14] In dicta, the D.C. Circuit also called into question, but did not explicitly overturn, what it called the "open-endedness" of the Commission's "touchstone" of impairment -- uneconomic entry -- and the Commission's treatment of impairment in relation to universal service "cross-subsidies."[15]

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[10] "TELRIC" stands for "Total Element Long-Run Incremental Cost."

[11] This will raise issues about the hot cut capabilities of the incumbent.

[12] See Section III, below.

[13] *USTA II*, 359 F.3d at 565-68, 573-74, 594.

[14] Id. at 568-71, 574-75, 594.

[15] Id. at 571-73. The Court also vacated the Commission's distinction between "qualifying" and "non-qualifying" services (id. at 591-92, 594) and, in the context of reviewing the Commission's findings on dedicated transport, vacated and remanded the failure by the Commission to consider alternative network access arrangements, such as tariffed offerings, offered by incumbent LECs. *USTA II,* 359 F.3d at 577, 592, 594. The D.C. Circuit also (continued….)

*USTA II* did leave intact -- because no party challenged it -- the Commission's national finding of impairment for mass market loops. This means that mass market loops must continue to be unbundled at TELRIC rates.[16]

Several parties have sought Supreme Court review of the *USTA II* decision.[17] By that very token, *USTA II* is not yet final, nor is it a definitive statement of the law.[18]

The Commission has sought comment on numerous key issues. In these comments -- especially given the brief period allowed for comment[19] -- NASUCA focuses on the UNEs that make up the unbundled network element platform ("UNE-P"), which is the source of most of the current competitive opportunities available to residential customers, and a significant portion for small business customers.[20] Specifically, these comments focus on unbundled local switching ("ULS").

We begin by noting issues raised by the FCC in its Order that are of particular concern to

(Continued from previous page)

remanded, but did not vacate, other portions of the *Triennial Review Order*, including the exclusion of entrance facilities from an impairment analysis. Id. at 585-86, 594.

[16] The Supreme Court noted in *Verizon v. FCC*, 535 U.S. 467, 490-491 (2002) ("*Verizon*"), that the loop would be "the most costly and difficult" to duplicate,

[17] *See* National Association of Regulatory Utility Commissioners and the Arizona Corporation Commission, Petition for a Writ of Certiorari, No. 04-12 (June 30, 2004); AT&T Corp., *et al*., Petition for a Writ of Certiorari, No. 04-15 (June 30, 2004); People of the State of California, *et al*., Petition for a Writ of Certiorari, No. 04-18 (June 30, 2004).

[18] A major thrust of these comments is to compare the D.C. Circuit's pronouncements in *USTA II* and *United States Telecom Ass'n. v. FCC*, 290 F.3d 414 (D.C.Cir. 2002) ("*USTA I*") to the Supreme Court's rulings in AT&T Corp. v. *Iowa Utils. Bd. v. FCC*, 525 U.S. 366 (1999) ("*Iowa Utilities*") and *Verizon*.

[19] Caused by the Commission's delay first in adopting and then in releasing the interim Order and NPRM.

[20] See NASUCA ex parte letter (February 13, 2002) at 2-3. Chairman Powell's negative view of the UNE-P is demonstrably false. Statement of Chairman Michael K. Powell at 1. The UNE-P is a combination of elements that is ordinarily combined in the ILECs' networks; such combinations must be made available to CLECs and may not be broken apart before being leased to the CLECs. cite The fact that this combination of elements can be used to provide most telecommunications services does not change its legal footing.

NASUCA, and by summarizing NASUCA's views on those issues.[21]

- The Commission seeks comment on how to respond to the D.C. Circuit's *USTA II* decision in establishing sustainable new unbundling rules under sections 251(c) and 251(d)(2) of the Act.[22]

*Consistent with the Act and the United State Supreme Court decisions, the FCC should order unbundling of UNE-P. The USTA I and USTA II decisions are not final authority. These decisions did not follow the Chevron*[23] *doctrine, by failing to accord deference to the FCC's rulings in these matters.*

*In that context, NASUCA makes the following recommendations. The recommendations assume, arguendo, that the pronouncements of the D.C. Circuit in USTA I and USTA II -- despite not being definitive -- are entitled to deference.*

*The D.C. Circuit found fault with the Commission's impairment standard, and with the delegation of decision-making authority to the states. In USTA I, the D.C. Circuit required the Commission to analyze impairment on a granular basis. The Commission should, therefore, perform a granular analysis following an impairment standard that addresses the concerns of the D.C. Circuit. That would include dividing the mass market into its two customer class components, residential and small business service.*

*Yet the Commission does not have a granular record, especially for mass market switching. The Commission should perform the granular analysis based upon the records submitted by the state commissions and other parties. This granular analysis requires deciding on the proper product markets and the proper geographic markets, and then applying the impairment standard to those markets.*

*The FCC should decide the proper product markets. One of those markets should be the residential market on a standalone basis.*[24] *The states' judgments about the appropriate geographic markets should generally be followed.*[25] *USTA II forbade the Commission from subdelegating decision-making to the states; it did not forbid the Commission from asking the states to perform fact-finding.*[26]

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[21] Other issues are not addressed here. NASUCA reserves the right to address those issues on reply.

[22] NPRM, ¶ 9, citing 47 U.S.C. §§ 251(c), (d)(2).

[23] *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 866 (1984) ("*Chevron*").

[24] This is supported by the states' records, which show that the Commission's definition of the "mass market" product market was overbroad, and should be divided between separate residential and small business markets.

[25] The *USTA II* decision asserts that "the Commission gave the states virtually unlimited discretion over the definition of the relevant market." 359 F.3d at 564, citing *Triennial Review Order*, ¶¶ 495-497.

[26] *USTA II*, 359 F.3d at 567.

*To the extent that the records of the state proceedings show clearly that there is no impairment under the standard enunciated by the D.C. Circuit, the Commission should find that the ILEC in that area is not required to supply that UNE pursuant to sections 251(c) and 251(d)(2) of the Act. Where the record is not clear, the Commission should request that the state commission perform further fact-finding necessary on specific facts.*[27]

- The Commission seeks comment on how best to define relevant markets (e.g., product markets, geographic markets, customer classes) to develop rules that account for market variability and to conduct the service-specific inquiries to which *USTA II* refers.[28]

*These will be a particular focus of NASUCA's comments. The D.C. Circuit did not overturn, but raised questions about what the Commission did to define markets. The Commission set product market/customer class distinctions (really without distinguishing the two), specifically for the "mass market" and the "enterprise market."*[29] *Yet the record from the states shows that the mass market is not a single product market. Instead, there needs to be separate residential and small business product markets. This is also consistent with D.C. Circuit's issue of universal service support.*

*As to geographic markets, that seems especially appropriate to leave that determination to the states. The Commission should accept state determinations unless a party to the state specifically objects. It appears, for most states, that the appropriate geographic market is smaller than the Metropolitan Statistical Area ("MSA") but typically larger than the individual wire center.*

- Also, we seek comment on how to respond to the D.C. Circuit's guidance on other threshold factors, including the relationship between universal service support and UNEs.[30]

*The support flows discussed by the D.C. Circuit are legacies of monopoly status, and were established in the public interest. The D.C. Circuit appears to believe that the support flows should negate the need for unbundling, because this is not "impairment" as the Court would define it. The Court had it backwards: The support flows make certain that service to residential customers using UNEs is less profitable, less economic, than service to business*

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[27] The Commission seeks comment "on the changes to the Commission's unbundling framework that are necessary, given the guidance of the *USTA II* court." NPRM, ¶ 9. NASUCA's response to this question is as just discussed, unless the Commission intends to draw a distinction between "rules" and "framework."

[28] NPRM, ¶ 9. See, e.g., *USTA II*, 359 F.3d at 575-577, 591-592 (requiring Commission to analyze impairment for all "telecommunications services" and suggesting that the impairment analysis must account for specific characteristics of the market in which a particular requesting carrier operates).

[29] *Triennial Review Order*, ¶¶ 421, 497.

[30] NPRM, ¶ 9.

*customers.*[31] *Hence for residential customers impairment is more often present, rather than less. Contrariwise, there is less likely to be impairment for the large business customers that have traditionally been thought of as the source of the support.*

- Moving beyond the threshold unbundling issues, we seek comment on how to apply the Commission's unbundling framework to make determinations on access to individual network elements.

*NASUCA discusses both substantive and process issues.*

The Commission also sought comment on the results of the Commission-mandated, *USTA II*-overturned state impairment proceedings. The Commission stated:

> Given that our inquiry raises complex issues, and proceedings that state commissions initiated to implement the *Triennial Review Order* developed voluminous records containing information potentially relevant to our inquiry, we anticipate that parties might wish to submit much of that same factual evidence to support their positions here.[32]

NASUCA itself was not a participant in those individual state proceedings, but many of its members did participate. Some NASUCA members are filing detailed responses to the Commission's request for comment on granular analyses.[33] Because of the procedural posture of the impairment cases, and because those cases were conducted prior to *USTA II*'s further objections, the records may be in some respects inadequate and incomplete. The Commission should ask the states to supplement the record, if necessary, based on guidelines it develops.

- Similarly, we encourage state commissions and other parties to summarize state commission efforts to develop batch hot cut processes.[34]

*NASUCA does not address this issue elsewhere in these comments, primarily because the issue arises only out of a desire to cure impairment where found, or to adopt measures as*

[31] That is, unless the competitor had the same access to the support flows as the incumbent.

[32] NPRM, ¶ 15.

[33] See, e.g., Comments of the Office of the Ohio Consumers' Counsel.

[34] NPRM, ¶ 15.

*alternatives to unbundling, based on the extreme limiting view of the D.C. Circuit. The Commission can still use hot cut issues as bases to support the other unbundling findings, but need not and should not require states to develop hot cut processes as a means of restricting unbundling.*

These comments first set forth the legal principles on which the Commission's unbundling decisions must be based.[35] In order to show the importance to the public interest, NASUCA then discusses what the current unbundling regime has produced: the beginnings of a competitive local service market for residential customers. Based on the principles and the benefits of unbundling, NASUCA makes specific recommendations for how the Commission should review impairment and order unbundling, focusing on local switching.[36] These comments conclude with a detailed review of the law on unbundling which is the basis for the principles,

## II. THE PRINCIPLES THAT GOVERN UNBUNDLING

In Section VII, infra, NASUCA presents a detailed chronological review of the law regarding unbundling. In this section, NASUCA presents principles gleaned from that review, with citations to the controlling case law.

- Congress recognized the need to open the incumbents' networks for competition. ***Verizon***, **535 U.S. at 490-492.**
- In administering § 251(c), the Commission can consider whether to adopt policies that encourage competitors to enter. **Id. at 503-504.**
- Congress did not intend to disfavor unbundling among the three means of competition identified in the Act. **Id. at 475, 488-489, 490-491, 491-492.**[37]
- The Commission's judgment on which UNEs should be made available is entitled to *Chevron* deference. **Id. at 502, citing *Chevron,* 467 U.S. at 866; see also**

[35] The principles are more fully discussed in the chronological review of unbundling orders in Section VII, below.

[36] In Section V, shared transport is briefly discussed.

[37] See also id. at 495 (the 1996 Act did not include a requirement that competitors own or construct facilities).

***Verizon*, 535 U.S. at 501-501, quoting *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968).**

- ILECs must make UNEs available to CLECs when the CLECs are "impaired" without access to the UNEs. **47 U.S.C. § 251(c)(2)**.
- The Commission must, however, apply some limiting standard in interpreting impairment. ***Iowa Utilities*, 525 U.S. at 388.**
- The term "impairment" should be interpreted according to the "ordinary and fair" meaning of the word. **Id. at 389-90 & n.11.**
- The markets in which impairment must be measured are product/customer class markets and geographic markets. ***USTA I*, 290 F.3d at 422.**
- The Commission must consider self-provisioning or acquisition from a third party as factors that indicate a lack of impairment. ***Iowa Utilities*, 525 U.S. at 389.**
- The Commission cannot consider the mere fact of competitive disadvantage as meeting the impairment standard. **Id. at 389-90, n.11.**
- "Hot cuts" standing alone cannot demonstrate impairment on a national basis for local switching. ***USTA II*, 359 F.3d at 569.**
- The Commission's "there is impairment where entry is uneconomic" test meets the *Verizon* requirements of a limiting standard rationally related to the goals of the Act. ***Verizon*, 535 U.S. at 509-510; see *Triennial Review Order*, ¶ 84; see also *USTA II*, 359 F.3d at 571-572.**[38]
- A concept of impairment, with the costs of unbundling brought into the analysis under § 251(d)(2)'s "at a minimum" language, is acceptable. ***USTA II*, 359 F.3d at 572.**

Given proper *Chevron* deference, rules based on these principles should withstand court review. Further, for reasons more fully discussed below, the Commission should presume now that there is impairment for unbundled local switching, subject to review of the facts elicited in the state proceedings.

[38] Although a finding of impairment cannot be based solely on the costs of hot cuts (id. at 569), the cost of hot cuts is a factor that can be considered in the impairment analysis.

There are three aspects of *USTA II*, however, that the Commission should not accept as authoritative: First, the D.C . Circuit's focus on cost differences arising from natural monopoly.[39] As shown in Section VII, this focus resulted in the D.C. Circuit imposing extraordinary extrastatutory requirements before unbundling would be allowed. The second aspect is the D.C. Circuit's insistence that the Commission seek "more nuanced alternatives" to unbundling.[40] This is also based on unbundling being viewed as a disfavored alternative to facilities-based competition.

The third is the question of the impact of traditional ratemaking methods on the unbundling regime.[41] As discussed in Section VI, the fact that traditional ratemaking has made competing for residential customers more difficult represents an impairment that *requires* unbundling for service to those customers,[42] rather than being a reason not to unbundle.

## III. WHAT THE WORLD LOOKS LIKE NOW AS A RESULT OF THE CURRENT LEVEL OF UNBUNDLING

The Commission's most recent Local Competition Report shows how important unbundled local switching has become to local service competition. Table 4 of that Report shows that in December 2001, 42% of local competition was accomplished with ULS; in

[39] Id. at 572.

[40] Id.; see also *Triennial Review Order*, ¶¶ 486-490

[41] *USTA II*, 359 F.3d at 573.

[42] Indeed, under conventional wisdom, it is a vestige of natural (or at least legal) monopoly and would not have occurred without it.

December 2002, that had grown to 59%.[43] As of December 2004, 61% of local competition was accomplished with ULS.[44]

In many states, much of the ULS-based competition is for residential customers. Looked at another way, the vast majority of residential competition uses the UNE-P, of which ULS is a critical element. For example, in Ohio, over 90% of residential competition in SBC Ohio territory -- which represents most of the residential competition in the state -- is accomplished through UNE-P.[45] This shows clearly that the result of the removal of ULS and UNE-P from the list of unbundled elements would be devastating to residential competition.[46]

The actions of the RBOCs post-*USTA II* and *Triennial Review Order* have also had a strong influence. After *Iowa Utilities*, in which the Supreme Court invalidated the Commission's impairment rules, unbundling -- including the UNE-P continued apace.[47] Indeed, after *USTA I*, the RBOCs continued to unbundle local switching in the absence of court-approved unbundling rules. Yet now, after *USTA II*, the RBOCs seem determined to act against unbundling.[48]

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[43] Industry Analysis Division, *Local Telephone Competition: Status as of December 31, 2003* (June 2004), Table 4.

[44] Id.

[45] See 01-338, NASUCA ex parte filing (February 13, 2004) at 2.

[46] The uncertainty arising from *USTA II*, combined with the wholesale price increases ordered by state commissions as a result of the RBOCs' complaints, may mean that the December 2003 level of competition for residential customers was a high-water mark. These events have caused retrenchment in the CLECs' determination and ability to serve residential customers.

[47] See *Local Telephone Competition: Status as of December 31, 2003* (June 2004), Table 4.

[48] See SBC Ohio v. ACC Teelcommuincations Serfvices, et al., PUCO Case No. 04-1450-TP-CSS (filed September 21, 2004); accessible at http://dis.puc.state.oh.us/dis.nsf/0/DB0AE84B4A9A1A0B85256F1700666D81?OpenDocument.

This history shows that this Commission cannot and should not make abrupt changes that will crush the competition that residential customers are finally now enjoying, eight years after the Act went into effect. Residential competition remains the unfulfilled promise of the Act.[49]

## IV. NASUCA'S RECOMMENDATIONS AS TO UNBUNDLING OF LOCAL SWITCHING SERVING RESIDENTIAL CUSTOMERS

In the *Triennial Review Order*, the Commission found impairment on a national basis for mass market copper loops.[50] This was based on an extensive review of actual loop deployment and the economics of loop deployment.[51] No party has challenged that national finding. Thus the Commission's overall approach to the impairment analysis was correct; it was the application of the analysis -- including the reliance on hot cuts and the establishment of a national standard without a granular, nuanced, review of the record -- that was overturned by *USTA II*.[52]

NASUCA's recommendation to the Commission comes in two parts designed to constitute a nuanced approach to the unbundling of local switching. First, there is the issue of what markets should be examined for the impairment analysis. Second, having defined the markets, how should impairment be measured?

### A. The first market consideration is customer class.

In discussing ULS, the Commission asked the states to look at the product dimension

[49] Especially in light of the fact that all of the RBOCs have been able to enter the interLATA service market pursuant to 47 U.S.C. § 271.

[50] *Triennial Review Order*, ¶ 211.

[51] See Section VII.G, below.

[52] See Section VII.H, below.

based on two markets: ULS used to serve the mass market and ULS used to serve the enterprise market.[53] Although for ULS purposes, the Commission initially combined the residential product market and the small business product market into a single classification -- the "mass market" -- a properly granular analysis should review impairment for each product due to the substantial differences between residential service and business service -- even small business -- service.

In the *Triennial Review Order*, the Commission distinguished "*three* classes of customers -- mass market, small and medium enterprise, and large enterprise…."[54] The Commission stated that

> [t]hese classes can differ significantly based on the services purchased, the costs of providing service, and the revenues generated. Because of these differences, for certain network elements the determination whether impairment exists may differ depending on the customer class a competing carrier seeks to serve.[55]

For the purpose of establishing whether competitors are impaired without access to ULS, the mass market should be subdivided into the residential and business markets. The residential/small business market split illustrates that these markets vary in precisely the terms the FCC used to separate product markets.

Nothing in the *Triennial Review Order* would prevent a subsequent Commission finding separating the residential and small business markets.[56] Separating the markets is consistent with

[53] *Triennial Review Order*, ¶¶ 421-422.

[54] Id., ¶ 124 (emphasis added).

[55] Id.

[56] See, e.g., *Triennial Review Order*, ¶ 496.

the D.C. Circuit's discussion in *USTA II*.[57]

As a practical matter, such a distinction is vital to the continued existence and further growth of a competitive market for residential customers. The existence of competition for small business customers has virtually no impact on the choices available to residential customers, if the CLECs providing small business service do not also offer competitive options for residential customers. A finding of no impairment for residential customers based on competition for small business customers defies logic and contradicts the intent of the 1996 Act.

The Commission should recognize and preserve the residential/small business differential so that the different competitive conditions faced by residential and business customers will not be lost. The key factor distinguishing between residence and business service, including small business service, in most states is retail rates.[58] These retail rates -- substantially higher for business customers than for residential customers -- have a significant impact on the economics of serving each class.[59] CLECs recognize these differences and as a result have chosen to enter the small business market while staying out of the residential markets. As long as the competitive service providers recognize the separate markets, the Commission should also.

If the Commission treats residential and small business customers as part of the same market, and there is no finding of impairment in that market based on service to small business customers, then residential customers will be denied the benefits of UNE-P competition despite the fact that there is impairment for service to residential customers without access to ULS.

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[57] See Section VI, below.

[58] See Comments of the Office of the Ohio Consumers' Counsel, at 14-15. Other factors, such as usage charges also show differences. See id. at 15.

[59] Id.

Forcing residential and business customers into the same market, when there are so many differences between them, creates the risk that, for residential customers, the Commission would declare a lack of impairment where impairment actually exists.

Which is not to say that it should be a foregone conclusion that, in a particular state in a particular market, there is no impairment for service to either residential or small business customers or both. The Commission must make that judgment based on the state records. It should be clear, however, if the state record shows that there is impairment for the mass market customers, then it should be presumed that impairment exists for **both** residential and small business customers.

**B. The second market consideration is geographic.**

In the *Triennial Review Order*, the Commission gave state commissions considerable discretion to determine the contours of the relevant markets in their state.[60] However, the Commission did place some limitations on that discretion. First, a state commission was required to use the same market definition for both the "trigger" analysis and the economic impairment analysis. Second, a state commission was not to define the market to encompass the entire state.[61] Third, a commission was not to define the market so narrowly "that a competitor serving that market alone would not be able to take advantage of available scale and scope economies from serving a wider market."[62] Finally, a state commission was to "attempt to distinguish among markets where different findings of impairment are likely."[63]

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[60] *Triennial Review Order*, ¶ 495.

[61] Id. This suggests that even in small states like Connecticut and Rhode Island, there are to be multiple markets.

[62] Id.

[63] Id.

The Commission also said that state commissions were to consider the following:

• The locations of customers actually being served (if any) by competitors;

• The variation in factors affecting competitors' ability to serve each group of customers;

• Competitors' ability to target and serve specific markets economically and efficiently using currently available technologies; and

• How competitors' ability to use self-provisioned switches or switches provided by a third-party wholesaler to serve various groups of customers varies geographically.[64]

The Commission also gave specific examples of additional factors that states could consider in defining the relevant market:

• How UNE loop rates vary across the state;

• How retail rates vary geographically;

• How the number of high-revenue customers varies geographically;

• How the cost of serving customers varies according to the size of the wire center and the location of the wire center; and

• Variations in the capabilities of wire centers to provide adequate collocation space and handle large numbers of hot cuts.[65]

The FCC also noted that states had, in fact, made determinations on markets, such as retail ratemaking, the establishment of UNE loop rate zones, and the development of intrastate universal service mechanisms, and said that using these areas could be appropriate.[66]

The Commission should use the records from the state proceedings in order to determine, for the specific states, the specific geographic markets in which impairment should be measured.

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[64] Id.

[65] Id., ¶ 496.

[66] Id. It is difficult to see how the D.C. Circuit thought that these guidelines gave the states "virtually unlimited discretion…." *USTA II*, 359 F.3d at 564.

As with the residential vs. small business product markets, the Commission runs a risk if it makes the geographic markets too large.

NASUCA recommends a "bottom up" or "start small and build out" approach to defining geographic markets. This approach would establish geographic markets composed of clusters of ILEC wire centers with homogeneous characteristics. The clusters would generally be composed of contiguous wire centers that share key characteristics important for local exchange service, such as costs and customer density.

Such clusters of wire centers would allow CLECs to enjoy economies of scale, as required by the Commission,[67] but do not categorically exceed the notion of a unified market. This approach will allow the Commission to limit its findings of no impairment to those areas where there is truly no impairment, without erroneously affecting areas where there is impairment.

Geographic markets of larger scope should generally be avoided. For example, in many states, the RBOCs have proposed the use of Metropolitan Statistical Areas ("MSAs"), determined by the federal Office of Management and Budget ("OMB"), as the market over which impairment should be measured.[68]

MSAs -- even the portions of the MSA served by a specific ILEC -- do not generally constitute appropriate markets over which impairment can be measured. Conditions within the MSAs are far too diverse to make the MSA a single market for judging impairment. Further,

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[67] *Triennial Review Order*, ¶ 495.

[68] See, e.g., Public Utilities Commission of Ohio Case Nos. 03-2040-TP-COI, *In the Matter of the Implementation of the Federal Communications Commission's Triennial Review Regarding Local Circuit Switching*, Opinion and Order (January 14, 2004) at 24 ("*PUCO Market Definition Order*") (accessible at http://dis.puc.state.oh.us/cgi-bin/CMWebCGI.exe?ItemID=SIY7$JQHWDI6IL$W).

CLEC advertising and entry patterns do not show that the service is available to or offered to the mass market, much less the residential market.

The use of local access and transport areas ("LATAs") would also be overreaching. For example, in Ohio, Columbus, Ironton and Marietta are all in the Columbus LATA; Ripley and Piqua are in the Dayton LATA; and Lima and Mansfield (not SBC Ohio exchanges) are in the *noncontiguous* Mansfield/Lima LATA.[69] Identifying each of these as unified markets has no basis in reality.

Even more overreaching is the use of the respective incumbents' entire service territories be used to define the markets. By no stretch of the imagination, for example, can all parts of the SBC Ohio territory -- located in non-contiguous portions of northwest, northeast, central, southwest and southeast Ohio -- be viewed as a single market. This approach would include downtown Cleveland in Cuyahoga County and Ripley, 260 miles away in Brown County, in the same market.[70] Defining the non-contiguous metropolitan areas in Ohio served by SBC Ohio -- in the northwest, northeast, center and southwest of the state -- as a single market -- goes against the Commission's direction in the *Triennial Review Order*.[71]

If a state is divided into just a handful of broad markets, each containing widely varying market conditions, grave difficulties are encountered in performing a granular analysis. If large geographic areas are treated as a single market, the risk is that these broad markets will yield conclusions concerning impairment that are only valid for some customers (e.g., those in urban

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[69] See http://www.puc.state.oh.us/pucogis/statemap/lata.pdf.

[70] Id.

[71] *Triennial Review Order*, ¶ 495.

areas) and are not valid for other customers (e.g., those in adjacent suburbs or rural areas).

Broad areas such as MSAs and LATAs contain urban, suburban and rural components. Consequently, there are often extreme differences in operating and engineering characteristics between specific wire centers within each area. There will also be differences in available economies of scale with respect to inter-office transport facilities and collocation facilities. In turn, these differences translate into substantial differences in the cost of using a CLEC switch to serve mass market customers in different wire centers within a single area.

Similarly, the mix of high revenue customers and low revenue customers may differ throughout a broad geographic area. Hence, CLECs may confront entirely different conditions in considering the potential for using their own switch to serve mass market customers in different parts of the overall area. To overcome this difficulty, it is preferable to define the relevant markets on the basis of individual wire centers, or small clusters of wire centers having homogeneous characteristics.

Most of the state commissions had not come to a conclusion on market definition when *USTA II* came down. One state commission that had come to at least a tentative conclusion was the Public Utilities Commission of Ohio ("PUCO"). After a careful review of the record before it, the PUCO issued an Opinion and Order on January 14, 2004 that tentatively found that markets would be clusters of contiguous wire centers within an ILEC's UNE loop rate bands.[72] Later developments in the Ohio proceeding showed that a few of these clusters were still quite heterogeneous and needed to be subdivided.[73]

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[72] *PUCO Market Definition Order* at 24.

[73] See OCC Comments at 31-33.

By and large, this Commission should follow the findings of the state commissions, because their analyses were based on the circumstances of each state. As noted herein, the Commission must avoid markets so large as to run the risk of finding no impairment across an area and masking actual impairment in specific parts of that large market.

### C. The first measure showing lack of impairment is actual deployment.

As the Commission has stated, "evidence of self-deployment is the best indicator of whether competitive LECs have been able to overcome barriers to entry with respect to facilities deployment." [74] In the Triennial Review Order, the Commission directed the state commissions to find no impairment and eliminate unbundling of mass market switching if a market contained at least three competitors in addition to the ILEC,[75] or at least two non-ILEC third parties that offered access to their own switches on a wholesale basis.[76] These "triggers," as the best evidence of a lack of impairment, should be adopted by the Commission as its own standards. The Commission should then determine whether the triggers are met for residential and for small business customers in each geographic market.

### D. The second measure of impairment, in the absence of actual deployment, is whether deployment is uneconomic.

In the *Triennial Review Order*, where the competitive "triggers" were not met, the Commission instructed the states to consider whether, despite the many economic and operational entry barriers deemed relevant by the Commission, competitive supply of mass market switching was nevertheless economic, and required unbundling only where service was

[74] Id., ¶ 435.

[75] Id., ¶¶ 498-503.

[76] Id., ¶¶ 504-505.

uneconomic.[77] The D.C. Circuit asserted that "in at least one important respect the Commission's definition of impairment is vague almost to the point of being empty…. Uneconomic by whom?"[78]

NASUCA submits that one of the choices identified by the D.C. Circuit is most appropriate for use in this area: Impairment should be found if entry is uneconomic for "a

[77] Id., ¶¶ 494, 506-520.

[78] *USTA II*, 359 F.3d at 572.

hypothetical CLEC that 'used the most efficient telecommunications technology currently available,' the standard built into TELRIC…."[79] In *Verizon*, the Supreme Court approved this standard as meeting the language and intentions of the 1996 Act;[80] an impairment test consistent with this principle should stand on appeal. The Commission should evaluate the records from the states to see if there is a showing of "uneconomic" impairment for the specific geographic markets.

**E. The status of the state records**

When the Commission "subdelegated" impairment issues to the states, it said that the states had to complete their proceedings within nine months of the effective date of the *Triennial Review Order*.[81] Otherwise, the Commission would, in a largely unspecified fashion, take the issue away from the dilatory state.[82]

States took a variety of approaches to meeting the Commission's directives. Some gave their ILECs the opportunity to challenge the finding of impairment for mass market switching. In some states, no ILEC came forth to challenge the finding. As discussed above, given the fact that a reassessment of the record would support a presumption of impairment, the Commission should continue that presumption in those states where there was no challenge. In other states, some ILECs challenged the finding where others did not. Again, the presumption should stand in those territories where no challenge was made.

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[79] Id.

[80] *Verizon*, 535 U.S. at 522.

[81] Triennial Review Order, ¶ 527. That date was July 2, 2004.

[82] Id., ¶ 190.

Some of the ILECs that challenged the impairment finding did so only for parts of their territories. Where an ILEC left the finding unchallenged -- especially if the ILEC actively challenged other parts of the territory -- the presumption should continue.

The territory where the ILECs challenged the impairment finding is where the Commission will have to do a review of the state record to determine impairment. Only in that territory did the ILEC believe that the granular reality outweighed the generic national finding.

Of course, the states conducted their reviews with a wide variety of procedures. As best as can be determined, however, no state that was required to assess impairment for ULS -- because an ILEC had challenged the national finding -- was able to finalize its proceeding before the *USTA II* decision was issued four months after the *Triennial Review Order*'s effective date.

Thus in reviewing the summaries of the records submitted by the state commissions and other parties, the Commission will have to determine whether that record is complete enough to make a judgment on impairment. If the record is not complete, the Commission will have to direct the states to respond to specific inquiries to supplement the record.

If the Commission does not direct the states to undertake fact-finding required to make the granular unbundling assessment that is so dependent upon local conditions in the areas where the ILEC has challenged the presumption of impairment for mass market switching, the Commission will have to undertake the task itself. Such determinations are, quite obviously, best made by the states.

## V. AS IN THE *TRIENNIAL REVIEW ORDER*, SHARED TRANSPORT SHOULD FOLLOW SWITCHING.

In the *UNE Remand Order*, the FCC found that without access to shared transport, requesting carriers are impaired in their ability to use unbundled local circuit switching.[83] Following up in the *Triennial Review Order*, the Commission reiterated the necessary linkage between shared transport and local switching:

> Incumbent LECs and competitive LECs demonstrate that the use of unbundled shared transport is tied exclusively to unbundled local switching. Verizon and SBC assert that because switching and shared transport are inextricably linked, if incumbent LECs are no longer obligated to unbundled switching, they should no longer be obligated to unbundled shared transport. We agree. Therefore, we find that requesting carriers are impaired without access to unbundled shared transport only to the extent that we find they are impaired without access to unbundled switching .[84]

As a consequence, the Commission requested that states incorporate into their impairment analyses of unbundled circuit switching the economic characteristics of shared transport and other backhaul.[85] This rationale should also apply to the Commission's own review of impairment for shared transport.

## VI. THE IMPLICATIONS OF THE D.C. CIRCUIT'S "RATES BELOW COSTS" ISSUE FOR UNBUNDLING

The Act requires unbundling where CLECs are impaired without access to the ILECs' facilities.[86] The D.C. Circuit has twice faulted the Commission for finding impairment without

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[83] *UNE Remand Order*, 15 FCC Rcd 3696 at 3862-66, ¶¶ 369-379.

[84] *Triennial Review Order*, ¶ 534 (citations omitted).

[85] Id.

[86] 47 U.S.C. § 251(c)(3).

adequately addressing (in the D.C. Circuit's view) the issue of support flows between business customers and residential customers, and between urban customers and rural customers.[87] In *USTA II*, the D.C. Circuit referred to the Commission's fifteen-paragraph discussion of the issue as "brief."[88] Clearly, the D.C. Circuit was predisposed to reject any Commission decision that allowed unbundling in the face of this supposed historic "subsidy." And the D.C. Circuit's discussion does not include the classic economic definition of "subsidy": A service is subsidized if it is priced below its incremental cost, and a service is providing a subsidy if it is priced above its stand-alone cost.

Even the D.C. Circuit acknowledged that the definition of cost -- so that one can determine where rates are "below cost" and where above -- is uncertain. The D.C. Circuit stated, "We recognize, of course, that the historic accounting costs relied upon by state regulators are, like TELRIC itself, an artificial construct that may not closely track true economic cost."[89] The D.C. Circuit went on, however, to state, "[T]hat is no justification for the Commission's refusal to evaluate the probable consequences of its approach, and to adopt, in the light of those estimations, a policy that it can reasonably say advances the goals of the Act."[90]

The D.C. Circuit's confusion over the cost issue goes back to *USTA I*. There, the D.C. Circuit cited the "evidence" that supported its focus on this issue:

> One reason for such market-specific variations in competitive impairment is the cross-subsidization often ordered by state regulatory commissions, typically in the name of universal service. This usually brings about undercharges for some

[87] *USTA I*, 290 F.3d at 422-423; *USTA II*, 359 F.3d at 573.

[88] *USTA II*, 359 F.3d at 573.

[89] Id.

[90] Id.

> subscribers (usually rural and/or residential) and overcharges for the others (usually urban and/or business). Petitioners' opening brief in the Local Competition Order case cites testimony of a former FCC Chairman for the proposition that 40% of telephone service is charged below cost, Petitioners' Br. at 35 & n.16, and the Commission and its supporting intervenors do not demur. See also, e.g., Robert W. Crandall & Thomas W. Hazlett, *Telecommunications Policy Reform in the United States and Canada*, at 18, Working Paper 00-9, AEI-Brookings Joint Center for Regulatory Studies (Dec. 2000) (chart showing that in many American cities, businesses are charged substantially more than residences for single lines); see also generally Robert W. Crandall & Leonard Waverman, Who Pays For Universal Service? When Subsidies Become Transparent (2000).[91]

It is hard to see how an issue that is based on vague testimony before Congress -- which the Commission then failed to attempt to rebut -- and on an academic article that asserts that business rates are higher than residential rates -- saying little about relative costs -- could have such viability. Suffice it to say that this Commission has never examined residential rates around the country to determine whether they are below "cost," however that term may be defined.[92] And neither can the Commission request such an inquiry of the states, without setting clear parameters for the inquiry.

In any event, however, despite the assertions by the D.C. Circuit, such an inquiry is fundamentally irrelevant to the questions of impairment and unbundling. One can easily examine the "possible consequences" of an unbundling regime, even assuming that subsidies exist. The following table does just that:

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[91] *USTA I*, 290 F.3d at 422.

[92] As an example of how this issue has played out in real life, SBC Ohio has opted-in to an indefinite term alternative regulation plan that caps a uniform residential rate throughout the state at $6.50 (excluding usage), with business single line rates priced at $15.95. Likewise, Cincinnati Bell Telephone Company has opted-in to a similar plan that caps residential flat rates at $16.75 and business flat rates at $46.25. These are scarcely the actions of companies concerned about below-cost residential rates, or of companies that have a righteous fear of being "used as a piñata." *USTA II*, 359 F.3d at 573.

| **Area where unbundling might be required** | **Impact on support flows if there is unbundling**[93] | **Is an impairment finding for that class more or less likely?** |
|---|---|---|
| Business customers | Reduces flow to residential customers | Less |
| Urban residential customers | Reduces flow to rural residential customers | Less |

As the Commission has stated,

> Our impairment standard is unlikely to result in unwarranted unbundling in the case of areas and services for which local exchange rates generally exceed the incumbent LEC's costs. In fact, the service in urban areas and the enterprise services, which have tended to be priced "above" the incumbent LEC's "costs" have generally been the first areas to attract competitive entry, probably due to the relatively high revenue opportunities available. Thus, these areas and services are the ones for which marketplace evidence of facilities-based competitive entry is most likely to warrant a finding of no impairment.[94]

This clearly addressed the concern in *USTA I*, based on the Commission's earlier blanket unbundling regime, that "UNEs will be available to CLECs in many markets where there is no reasonable basis for thinking that competition is suffering from any impairment of a sort that might have been the object of Congress's concern."[95]

This also addresses the concern expressed in *USTA II* about TELRIC rates.[96] The D.C. Circuit stated,

> The interesting case is the one where TELRIC rates are so low that unbundling *does* elicit CLEC entry, enabling CLECs to cut further into ILEC revenues in

[93] On the assumption that retail revenues will be replaced by TELRIC-based UNE revenues.

[94] *Triennial Review Order*, ¶ 166 (footnote omitted).

[95] *USTA I*, 290 F.3d at 422.

[96] It should be recalled that the Commission's determination of the TELRIC rate structure was upheld by the Supreme Court in *Verizon*. Here again, this is an area where the D.C. Circuit failed to give the Commission's decisions *Chevron* deference.

> areas where the ILECs' service is mandated by state law -- and mandated to be offered at artificially low rates funded by ILECs' supracompetitive profits in other areas. If the scheme of the Act is successful, of course, the very premise of these below-cost rate ceilings will be undermined, as those supracompetitive profits will be eroded by Act-induced competition. In competitive markets, an ILEC can't be used as a piñata. The Commission has said nothing to address these obvious implications, or otherwise to locate its treatment of the issue in any purposeful reading of the Act.[97]

As the Commission noted, it is the areas that are the supposed source of these "supracompetitive" profits where unbundling is least likely to be ordered. And, presumably, not even the D.C. Circuit could object to erosion of the supracompetitive profits from facilities-based competition.

In the end, of course, the D.C. Circuit's concerns really have little to do with whether there is impairment for residential service, or with whether unbundling of network elements to serve residential customers "advances the goals of the Act."[98] Clearly, the requirement of unbundling in residential markets does not treat the ILEC as a piñata. And, as discussed earlier, the lower rates typically charged residential customers make impairment more common, rather than less.

## VII. A CHRONOLOGICAL REVIEW OF THE LAW ON UNBUNDLING

*USTA II* was the third time this Commission's unbundling rules were rejected by the courts. The latest two decisions -- *USTA I* and *USTA II* -- are hardly authoritative, especially in their failure to show *Chevron* deference to the Commission's decisions. NASUCA believes that the findings of *USTA II* would be rejected if considered by the Supreme Court, given the Court's

[97] *USTA II*, 359 F.3d at 573.

[98] Id.

adherence to *Chevron* deference in *Iowa Utilities* and *Verizon*. Nonetheless, the Commission should weigh carefully the various decisions; doing so should pass muster under the law.

An analysis of unbundling requires a detailed review of the statute, the Supreme Court's pronouncements, the Commission's responses to both the statute and the Supreme Court's pronouncements, and finally the D.C. Circuit's holdings. There has been much rhetoric about all of these; we need to get back to basics.

**A. The statute**

The 1996 Act requires that ILECs provide UNEs to other telecommunications carriers. In particular, section 251(c)(3) requires ILECs to provide to requesting telecommunications carriers "nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with ... the requirements of this section and section 252."[99] Section 251(d)(2)(B) authorizes the Commission to determine which elements are subject to unbundling, and directs the Commission to consider, "at a minimum," whether access to proprietary network elements is "necessary" and whether failure to provide a *non*-proprietary element on an unbundled basis would "impair" a requesting carrier's ability to provide service.[100] Section 252, in turn, requires that those network elements that must be offered pursuant to section 251(c)(3) be made available at cost-based rates.[101] For the purposes of these comments, we are addressing only the meaning of impairment. Defining "impairment" under the 1996 Act is hardly simple, evidenced by the Commission's repeated attempts in numerous orders addressing this very issue.

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[99] 47 U.S.C. § 251(c)(3).

[100] 47 U.S.C. § 251(d)(2)(B).

(Continued from previous page)

[101] 47 U.S.C. § 252(d)(1).

To put these issues into perspective, it is helpful to understand the purpose behind the Act itself. According to the FCC, the administrator of the 1996 Act's statutory scheme, the purpose of the Act is to "remove the outdated barriers that protect monopolies from competition and affirmatively promote efficient competition using tools forged by Congress."[102] Competition is desirable, not only as an end result, but primarily because competition is thought to create benefits to the end-user, that are greater than those benefits typically found under monopoly regulation. Such benefits as "new packages of services, lower prices and increased innovation" were the rationale behind the promulgation of the 1996 Act.[103] With this framework in mind, we proceed to analyze the subsequent pronouncements by the courts and the Commission that construed the 1996 Act.

### B. The *Local Competition Order*

The Commission first addressed the unbundling obligations of ILECs in the *Local Competition Order*, which, among other things, adopted rules designed to implement the requirements of section 251, establishing a list of seven UNEs which ILECs were obliged to provide to CLECs.[104] The Commission held that lack of unbundled access to an element would "impair" a CLEC's ability to provide telecommunications service "if the quality of the service the entrant can offer, absent access to the requested element, *declines* and/or the cost of

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[102] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket Nos. 96-98, 95-185, First Report and Order, 11 FCC Rcd 15499, 15616-775 (1996) ("*Local Competition Order*") (subsequent history omitted), ¶ 1.

[103] Id., ¶ 4.

[104] The seven network elements that the *Local Competition Order* required to be unbundled were: (1) local loops; (2) network interface devices; (3) local and tandem switching; (4) interoffice transmission facilities; (5) signaling networks and call-related databases; (6) operations support systems; and (7) operator services and directory assistance. Id., ¶ 27.

providing the

service *rises*."[105] Thus the Commission found that *any* competitive disadvantage represented impairment.

### C. The Supreme Court weighs in

In 1997, the U.S. Court of Appeals for the Eighth Circuit affirmed some parts of the *Local Competition Order* and reversed others.[106] On appeal, in January 1999, the Supreme Court issued *Iowa Utilities,* which (1) affirmed the Commission's general authority to adopt unbundling rules to implement the 1996 Act, (2) vacated the specific unbundling rules at issue, (3) instructed the Commission to revise the standards under which the unbundling obligation is determined, and (4) required the Commission to reevaluate which network elements were subject to unbundling under the revised standard.

Despite giving the Commission Chevron deference in other areas,[107] the Supreme Court found the Commission's reading of "impair" unreasonable in two respects. First, the Commission had not considered whether a CLEC could self-provision or acquire the requested element from a third party.[108] Second, the Commission had considered *any* increase in cost or decrease in quality, no matter how small, sufficient to establish impairment -- a result the Court concluded could not be squared with the "ordinary and fair meaning" of the word "impair."[109] The Court told the FCC that in assessing which cost differentials would "impair" a new entrant

[105] Id., ¶ 285 (emphasis added).

[106] *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997).

[107] *Iowa Utilities*, 525 U.S. at 387.

[108] Id., 525 U.S. at 389.

[109] Id. at 389-90 & n.11.

under the statute, it must "apply *some* limiting standard, rationally related to the goals of the Act."[110]

### D. The *UNE Remand Order*

In November 1999, the Commission responded to the Supreme Court's remand by issuing the *UNE Remand Order*, in which it reevaluated the unbundling obligations of ILECs and promulgated new unbundling rules, pursuant to the Court's direction. The Commission adopted a new interpretation under which a would-be entrant would be "impaired" if, "taking into consideration the availability of alternative elements outside the incumbent's network, including self-provisioning by a requesting carrier or acquiring an alternative from a third-party supplier, lack of access to that element *materially diminishes* a requesting carrier's ability to provide the services it seeks to offer."[111] The Commission thereby adopted a limiting standard, as required by the Supreme Court.

Numerous parties appealed the *UNE Remand Order* to the D.C. Circuit. While the appeal was pending, the U.S. Supreme Court decided *Verizon*, which specifically dealt with the Commission's TELRIC standard for pricing UNEs, but addressed many of the same fundamental issues as to the meaning of the 1996 Act's competition provisions, under which UNEs are to be made available to competitors at TELRIC rates.

### E. *Verizon* and § 251(c)

In *Verizon*, the Supreme Court introduced its discussion as follows:

> These cases arise under the Telecommunications Act of 1996. Each is about the power of the Federal Communications Commission to regulate a relationship

[110] Id. at 388 (emphasis in original).

[111] *UNE Remand Order*, ¶ 51 (emphasis added).

> between monopolistic companies providing local telephone service and companies entering local markets to compete with the incumbents. Under the Act, the new entrants are entitled, among other things, to lease elements of the local telephone networks from the incumbent monopolists.[112]

The Court went on:

> Under the local-competition provisions of the Act, Congress called for rate making different from any historical practice, to achieve the entirely new objective of uprooting the monopolies that traditional rate-based methods had perpetuated. A leading backer of the Act in the Senate put the new goal this way:
>
> "This is extraordinary in the sense of telling private industry that this is what they have to do in order to let the competitors come in and try to beat your economic brains out. . . .
>
> "It is kind of almost a jump-start. . . . I will do everything I have to let you into my business, because we used to be a bottleneck; we used to be a monopoly; we used to control everything.
>
> "Now, this legislation says you will not control much of anything. You will have to allow for nondiscriminatory access on an unbundled basis to the network functions and services of the Bell operating companies network that is at least equal in type, quality, and price to the access [a] Bell operating company affords to itself."
>
> … Congress passed a rate setting statute with the aim not just to balance interests between sellers and buyers, but to reorganize markets by rendering regulated utilities' monopolies vulnerable to interlopers, even if that meant swallowing the traditional federal reluctance to intrude into local telephone markets. The approach was deliberate, through a hybrid jurisdictional scheme with the FCC setting a basic, default methodology for use in setting rates when carriers fail to agree, but leaving it to state utility commissions to set the actual rates.[113]

The Court crystallized the key problem with local exchange competition:

> It is easy to see why a company that owns a local exchange … would have an almost insurmountable competitive advantage not only in routing calls within the exchange, but, through its control of this local market, in the markets for terminal equipment and long-distance calling as well. A newcomer could not compete with the incumbent carrier to provide local service without coming close to

[112] *Verizon*, 535 U.S. at 475.

[113] Id. at 488-489 (internal citations omitted).

> replicating the incumbent's entire existing network, the most costly and difficult part of which would be laying down the "last mile" of feeder wire, the local loop, to the thousands (or millions) of terminal points in individual houses and businesses. The incumbent company could also control its local-loop plant so as to connect only with terminals it manufactured or selected…. In an unregulated world, another telecommunications carrier would be forced to comply with these conditions, or it could never reach the customers of a local exchange.[114]

Notably, the Court did not give any indication that competitors' access was supposed to be limited to only "the most costly and difficult parts" of the incumbent's network. Indeed, the Court described the overall expansive strategy of the 1996 Act as follows:

> Section 251(c) addresses the practical difficulties of fostering local competition by recognizing three strategies that a potential competitor may pursue. First, a competitor entering the market … may decide to engage in pure facilities-based competition, that is, to build its own network to replace or supplement the network of the incumbent. If an entrant takes this course, the Act obligates the incumbent to "interconnect" the competitor's facilities to its own network to whatever extent is necessary to allow the competitor's facilities to operate. §§ 251(a) and (c)(2). At the other end of the spectrum, the statute permits an entrant to skip construction and instead simply to buy and resell "telecommunications service," which the incumbent has a duty to sell at wholesale. §§ 251(b)(1) and (c)(4). Between these extremes, an entering competitor may choose to lease certain of an incumbent's "network elements," which the incumbent has a duty to provide "on an unbundled basis" at terms that are "just, reasonable, and nondiscriminatory." § 251(c)(3).[115]

Significantly, the Court did not give any indication that the 1996 Act favored one of these routes to competition over another, or that any one of the routes was to be disdained. Indeed, the Court reiterated its holding in *Iowa Utilities* that upheld "the FCC's broad definition of network elements to be provided, and the FCC's understanding that the Act imposed no facilities-ownership requirement…."[116]

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[114] Id. at 490-491 (footnotes omitted).

[115] Id. at 491-492.

[116] Id. at 495 (internal citations omitted).

The Supreme Court recognized that "the breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties."[117] The Court also quoted *Chevron*: "When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail."[118]

Indeed, the Supreme Court majority upheld the FCC noting that "[w]hether the FCC picked the best way to set these rates is the stuff of debate for economists and regulators versed in the technology of telecommunications and microeconomic pricing theory. The job of judges is to ask whether the Commission made choices reasonably within the pale of statutory possibility in deciding what and how items must be leased and the way to set rates for leasing them. The FCC's pricing and additional combination rules survive that scrutiny."[119] The Supreme Court rejected Justice Breyer's failure, in his dissenting opinion, to give the Commission substantial deference.[120]

The Court also noted that

> even on Justice Breyer's own terms, FCC rules stressing low wholesale prices are by no means inconsistent with the deregulatory and competitive purposes of the Act. As we discuss below, a policy promoting lower lease prices for expensive facilities unlikely to be duplicated reduces barriers to entry (particularly for smaller competitors) and puts competitors that can afford these wholesale prices (but not the higher prices the incumbents would like to charge) in a position to build their own versions of less expensive facilities that are sensibly duplicable.

[117] Id. at 501, quoting *Permian Basin Area Rate Cases,* 390 U.S. 747, 790.

[118] *Verizon*, 535 U.S. at 502, quoting *Chevron,* 467 U.S. at 866.

[119] Id. at 539.

[120] Id. at 502, n. 20.

> And while it is true, as Justice Breyer says, that the Act was "deregulatory," in the intended sense of departing from traditional "regulatory" ways that coddled monopolies, that deregulatory character does not necessarily require the FCC to employ passive pricing rules deferring to incumbents' proposed methods and cost data.[121]

Clearly, the Supreme Court was indicating that the Commission's purpose in adopting TELRIC pricing was rationally related to the goals of the 1996 Act.

The Supreme Court also addressed head-on the arguments on facilities investment raised by the incumbents and Justice Breyer (and later adopted by the D.C. Circuit in *USTA I* and *USTA II*):

> The incumbents' (and Justice Breyer's) basic critique of TELRIC is that by setting rates for leased network elements on the assumption of perfect competition, TELRIC perversely creates incentives against competition in fact. The incumbents say that in purporting to set incumbents' wholesale prices at the level that would exist in a perfectly competitive market (in order to make retail prices similarly competitive), TELRIC sets rates so low that entrants will always lease and never build network elements. … According to the incumbents, the result will be, not competition, but a sort of parasitic free-riding, leaving TELRIC incapable of stimulating the facilities-based competition intended by Congress.
>
> We think there are basically three answers to this no-stimulation claim of unreasonableness: (1) the TELRIC methodology does not assume that the relevant markets are perfectly competitive, and the scheme includes several features of inefficiency that undermine the plausibility of the incumbents' no-stimulation argument; (2) comparison of TELRIC with alternatives proposed by the incumbents as more reasonable are plausibly answered by the FCC's stated reasons to reject the alternatives; and (3) *actual investment in competing facilities since the effective date of the Act simply belies the no-stimulation argument's conclusion*.
>
> …
>
> … In any event, the significance of the incumbents' mistake of fact may be indicated best not by argument here, but by the evidence of actual investment in facilities-based competition since TELRIC went into effect. … The FCC is, of course, under no obligation to adopt a rate setting scheme committed to realizing

[121] Id. (internal citations omitted).

> perfection in economic theory…
>
> Perhaps sensing the futility of an unsupported theoretical attack, the incumbents make the complementary argument that the FCC's choice of TELRIC, whatever might be said about it on its own terms, was unreasonable as a matter of law because other methods of determining cost would have done a better job of inducing competition. Having considered the proffered alternatives and the reasons the FCC gave for rejecting them, we cannot say that the FCC acted unreasonably in picking TELRIC to promote the mandated competition.[122]

The Supreme Court found that the competition induced by TELRIC rates was not "parasitic free riding."[123]

Finally, the Supreme Court addressed the key argument of the incumbents, endorsed so heartily by the D.C. Circuit, that unbundling at TELRIC rates discourages facilities investment:

> At the end of the day, theory aside, the claim that TELRIC is unreasonable as a matter of law because it simulates but does not produce facilities-based competition founders on fact. The entrants have presented figures showing that they have invested in new facilities to the tune of $55 billion since the passage of the Act (through 2000). The FCC's statistics indicate substantial resort to pure and partial facilities based competition among the three entry strategies: as of June 30, 2001, 33 percent of entrants were using their own facilities; 23 percent were reselling services; and 44 percent were leasing network elements (26 percent of entrants leasing loops with switching; 18 percent without switching). The incumbents do not contradict these figures, but merely speculate that the investment has not been as much as it could have been under other rate making approaches, and they note that investment has more recently shifted to nonfacilities entry options. We, of course, have no idea whether a different forward-looking pricing scheme would have generated even greater competitive investment than the $55 billion that the entrants claim, but it suffices to say that a regulatory scheme that can boast such substantial competitive capital spending over a 4-year period is not easily described as an unreasonable way to promote competitive investment in facilities.[124]

The Court also gave a final retort to Justice Breyer:

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[122] Id. at 503-504 (emphasis added).

[123] One would expect "synthetic" competition to amount to "parasitic free riding."

[124] Id. at 526.

> Nor, for that matter, does the evidence support Justice Breyer's assertion that TELRIC will stifle incumbents' "incentive . . . either to innovate or to invest" in new elements. As Justice Breyer himself notes, incumbents have invested "over $100 billion" during the same period. The figure affirms the commonsense conclusion that so long as TELRIC brings about some competition, the incumbents will continue to have incentives to invest and to improve their services to hold on to their existing customer base.[125]

In conclusion, the Supreme Court stated:

> We cannot say whether the passage of time will show competition prompted by TELRIC to be an illusion, but TELRIC appears to be a reasonable policy for now, and that is all that counts. See *Chevron,* 467 U.S. at 866. The incumbents have failed to show that TELRIC is unreasonable on its own terms, largely because they fall into the trap of mischaracterizing the FCC's departures from the assumption of a perfectly competitive market … as inconsistencies rather than pragmatic features of the TELRIC plan. Nor have they shown it was unreasonable for the FCC to pick TELRIC over alternative methods, or presented evidence to rebut the entrants' figures as to the level of competitive investment in local-exchange markets. In short, the incumbents have failed to carry their burden of showing unreasonableness to defeat the deference due the Commission.[126]

The "deference due the Commission" is what, shortly thereafter, the D.C. Circuit failed to give.

### F. *USTA I*

Within weeks after *Verizon* was issued, a panel of the D.C. Circuit vacated and remanded the portions of the *UNE Remand Order* interpreting the statute's "impair" standard and establishing a list of mandatory UNEs.[127] In *USTA I*, the D.C. Circuit acknowledged the difficulties facing the Commission in this area:

> We note at the outset the extraordinary complexity of the Commission's task. Congress sought to foster competition in the telephone industry, and plainly believed that merely removing affirmative legal obstructions would not do the job. It thus charged the Commission with identifying those network elements

[125] Id. at 517, n.33.

[126] Id. at 522.

[127] The court also vacated and remanded the Commission's line-sharing requirements.

whose

> lack would 'impair' would-be competitors' ability to enter the market, yet gave no detail as to either the kind or degree of impairment that would qualify.[128]

Nonetheless, the D.C. Circuit showed little or no deference to the Commission's interpretation, in contrast to the deference shown by the Supreme Court in *Verizon*.

The D.C. Circuit held that the fundamental problem was that the Commission did not differentiate between those cost disparities that a new entrant in *any* market would be likely to face and those that arise from market characteristics "linked (in some degree) to natural monopoly ... that would make genuinely competitive provision of an element's function wasteful."[129] In *USTA I*, the D.C. Circuit did not cite any authority to support its determination that the impairment analysis in section 251(d)(2) required consideration of market characteristics linked to natural monopoly, and did not explain how its view of impairment represented the "ordinary and fair" meaning of the term, as required by *Iowa Utilities*.

Rather, the D.C. Circuit stated that what it later called the Commission's "broad and analytically insubstantial concept of impairment"[130] failed to pursue the "balance" between the advantages of unbundling (in terms of fostering competition by different firms, even if they use the very same facilities) and its purported costs (in terms both of "spreading the disincentive to invest in innovation and creating complex issues of managing shared facilities").[131] The D.C. Circuit held, without any support, that this balance was "implicit" in the Supreme Court's

[128] *USTA I*, 290 F.3d at 422.

[129] Id. at 427.

[130] *USTA II*, 359 F.3d at 563.

[131] *USTA I*, 290 F.3d at 427.

insistence on an unbundling standard "rationally related to the goals of the Act."[132]

This far reaching pronouncement of the D.C. Circuit Court is not based upon any of the rationale -- implicit or explicit -- found in the majority opinions of Supreme Court decisions in *Verizon* or *Iowa Utilities*. Rather, it appears the Circuit Court was relying solely on the minority opinion of Justice Breyer, who dissented in both Supreme Court cases, and whose views were rejected by the majority in both cases. Again, there is no analysis of the "ordinary and fair" meaning of impairment that is required by the majority in *Verizon* and *Iowa Utilities*. Nor was there any recognition of the Supreme Court's views on facilities investment under the 1996 Act as expressed in *Verizon*. And, in the end, there was no Chevron deference such as that used by the Supreme Court.

The D.C. Circuit also objected to the Commission's decision in the *UNE Remand Order* to issue, with respect to most elements, broad unbundling requirements that would apply "in every geographic market and customer class, without regard to the state of competitive impairment in any particular market."[133] Although the D.C. Circuit held that the 1996 Act does not necessarily require the Commission to determine "on a localized state-by-state or market-by-market basis which unbundled elements are to be made available,"[134] it found that the 1996 Act does require "a more nuanced concept of impairment than is reflected in findings ... detached from any specific markets or market categories."[135]

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[132] Id. at 428, quoting *Iowa Utilities*, 525 U.S. at 388.

[133] *USTA I*, 290 F.3d at 422.

[134] Id. at 425, quoting *Third Report and Order*, 15 FCC Rcd at 3753, ¶ 122.

[135] *USTA I*, 290 F.3d at 426.

### G. The *Triennial Review Order*

In December 2001, prior to the D.C. Circuit's issuance of *USTA I*, the Commission released the *Triennial Review NPRM*, seeking comment regarding how, if at all, the unbundling regime should be modified to reflect market developments since issuance of the *UNE Remand Order*.[136] Following *USTA I*, the Commission asked commenters responding to the *Triennial Review NPRM* to address the issues raised in the D.C. Circuit's decision.[137]

The *Triennial Review Order* was announced in February 2003 but not released until August 2003. In the *Triennial Review Order*, based on the record compiled in response to the *Triennial Review NPRM*, the Commission adopted new unbundling rules implementing section 251 of the 1996 Act, attempting to comply with *USTA I*. The *Triennial Review Order* reinterpreted the statute's "impair" standard and reevaluated incumbent LECs' unbundling obligations with regard to particular elements.

The Commission determined that a CLEC would

> be impaired when lack of access to an incumbent LEC network element poses a *barrier or barriers to entry*, including operational and economic barriers, that are *likely to make entry into a market uneconomic*. That is, we ask whether all potential revenues from entering a market exceed the costs of entry, taking into consideration any countervailing advantages that a new entrant may have.[138]

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[136] *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Notice of Proposed Rulemaking, 16 FCC Rcd 22781 (2001).

[137] *See Wireline Competition Bureau Extends Reply Comment Deadline For The Triennial Review Proceedings*, CC Docket No. 01-338, Public Notice, 17 FCC Rcd 10512 (WCB 2002).

[138] *Triennial Review Order,* ¶ 84 (emphasis added).

The Commission clarified that the impairment assessment would take intermodal competition into account.[139]

The Commission responded to *USTA I*'s demand for a more "nuanced" application of the impairment standard by adopting a "granular" approach that would consider "such factors as specific services, specific geographic locations, the different types and capacities of facilities, and customer and business considerations."[140] Where the Commission believed that the record could not support an absolute national impairment finding but at the same time contained too little information to make "granular" determinations, it adopted a provisional nationwide rule, subject to the possibility of specific exclusions to be created by state regulatory commissions under a delegation of the Commission's own authority.[141]

The Commission concluded that ILECs must offer unbundled access to stand-alone copper loops, hybrid copper/fiber facilities and subloops for the provision of narrowband services to the mass market.[142] The FCC determined that its mass market analysis showed national impairment for loops based on general economic and operational factors that did not vary significantly by geographic region.[143]

The general economic and operational factors supporting the finding of national impairment for loops were utilized by the Commission in a balancing approach, where the

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[139] Id., ¶¶ 97-98.

[140] Id., ¶ 118.

[141] Id., ¶¶ 498-503.

[142] Id., ¶ 234.

[143] The FCC's unbundling of copper loops was not disturbed by the *USTA II* court, and hence remains in effect today.

Commission asked the question, Does the potential revenue opportunity exceed the cost, taking into consideration the relevant entry barriers?[144] The Commission focused on the economic characteristics of loop deployment such as scale economies, sunk costs, first-mover advantages, and other barriers within the control of the incumbent LEC.

The Commission noted that loop construction involves sunk fixed costs which act to hinder competition, given a competitor's constrained . ability to recover such costs.[145] The Commission also found that loops are costly, time consuming, and expensive to duplicate. Additionally, the Commission recognized CLEC difficulties in securing municipal and private rights of way. The Commission also discussed the incumbent LECs' inherent advantages over CLECs: first mover advantage, lack of delay in providing service, name recognition, and economies of scale.[146]

Although the Commission found there were revenue opportunities for loop construction where there could be rewards sufficient to offset uneconomic entry, it noted that the actual marketplace conditions contradicted this assumption. Rather, actual marketplace conditions showed minimal deployment of loops, minimal self-deployment of alternate copper loops, and no third parties offering alternative local loops on a wholesale basis.[147]

The Commission then made a similar nationwide finding that CLECs are impaired without unbundled access to ILEC switches for serving the "mass market," consisting of

[144] Id., ¶ 235.

[145] Id., ¶ 237.

[146] Id., ¶ 238.

[147] Id., ¶ 222.

residential and relatively small business users.[148] This finding was based primarily on the costs associated with "hot cuts," which must be performed when a CLEC provides its own switch.[149] Despite this blanket nationwide impairment determination, the Commission delegated authority to state commissions to make more "nuanced" and "granular" impairment determinations in order to overturn that determination.[150]

First, the Commission determined that the state commissions should find no impairment and eliminate unbundling of mass market switching if a market contained at least three competitors in addition to the ILEC,[151] or at least two non-ILEC third parties that offered access to their own switches on a wholesale basis.[152] For purposes of this exercise the Commission gave the states substantial discretion over the definition of the relevant geographic market, consistent with the states' familiarity with local competition.[153]

Second, where these "competitive triggers" were not met, the Commission instructed the states to consider whether, despite the many economic and operational entry barriers deemed relevant by the Commission, competitive supply of mass market switching was nevertheless feasible.[154] The Commission also instructed the states to explore specific mechanisms to

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[148] Id., ¶¶ 464-475.

[149] Id.

[150] Id. There was some record evidence of market-by-market variation in hot cut costs. Yet under a "fair and ordinary" definition of impairment, there was sufficient evidence in the record to support a nationwide finding of impairment for mass market switching and transport -- the elements that, in addition to loops, make up the UNE-P.

[151] Id., ¶¶ 498-503.

[152] Id., ¶¶ 504-505.

[153] Id., ¶¶ 495-497.

[154] Id., ¶¶ 494, 506-520.

ameliorate or eliminate the costs of the "hot cut" process.[155]

If a state failed to perform the requisite analysis within nine months, the Commission would step into the position of the state commission and do the analysis itself.[156] Finally, the Order provided that a party "aggrieved" by a state commission decision could seek a declaratory ruling from the Commission, though with no assurance when, or even whether, the Commission might respond.[157]

As discussed in Section V, above, the *Triennial Review Order* found that the impairment finding for shared transport followed from the switching finding.[158] Thus the Commission issued a national finding of impairment for shared transport for service to the mass market.[159]

### H. *USTA II*

On appeal, the same D.C. Circuit panel devastated the *Triennial Review Order*:

> We consider first whether the Commission's subdelegation of authority to the state commissions is lawful. We conclude that it is not. We then consider whether the Commission's nationwide impairment determination can nevertheless survive, even without the safety valve provided by subdelegation to the states. We conclude that it cannot. We therefore vacate the Commission's decision to order unbundling of mass market switches….[160]

Having rejected the Commission's subdelegation, the D.C. Circuit thereafter rejected "the (no

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[155] Id., ¶¶ 486-490. The Commission mentioned, for example, the possible use of "rolling" hot cuts, a process in which CLECs could use ILEC switches for some time after a customer selected the CLEC as its provider, and after an accumulation of such customer changes, the ILEC would make all the necessary hot cuts in one fell swoop. Id. , ¶¶ 463, 521-24.

[156] Id., ¶ 190.

[157] Id., ¶ 426; see also 47 CFR § 1.2.

[158] Id., ¶ 534.

[159] Id.

[160] *USTA II*, 359 F.3d at 564-565. For immediate purposes, the details of the D.C. Circuit's rejection of "subdelegation" are not pertinent.

longer provisional) national impairment finding as inconsistent with our conclusion in *USTA I* that the Commission may not 'loftily abstract[] away from all specific markets,' but must instead implement a 'more nuanced concept of impairment….'"[161]

With regard to the ILECs' claim about the open-endedness of the Commission's standard, the D.C. Circuit stated:

> [W]e observe that the Order's interpretation of impairment is an improvement over the Commission's past efforts in that, for the most part, the Commission explicitly and plausibly connects factors to consider in the impairment inquiry to natural monopoly characteristics (declining average costs throughout the range of the relevant market), or at least connects them (in logic that the ILECs do not seem to contest) to other structural impediments to competitive supply. These barriers include sunk costs, ILEC absolute cost advantages, first-mover advantages, and operational barriers to entry within the sole or primary control of the ILEC. In contrast to the First Report and Order and the Third Report and Order, the Commission has clarified that only costs related to structural impediments to competition are relevant to the impairment analysis.[162]

The D.C. Circuit noted, however, that "[i]n light of our remand, this is not the occasion for any review of the Commission's impairment standard as a general matter; it finds concrete meaning only in its application, and only in that context is it readily justiciable."[163]

In anticipation of future litigation, the D.C. Circuit did, however, offer a "few general observations" on the issues.[164] First, the D.C. Circuit stated:

> We note that there are at least two ways in which the Commission could have accommodated our ruling in *USTA I* that its impairment rule take into account not only the benefits but also the costs of unbundling (such as discouragement of investment in innovation), in order that its standard be "rationally related to the goals of the Act." One way would be to craft a standard of impairment that built

[161] Id. at 569, quoting *USTA I*, 290 F.3d at 423, 426.

[162] *USTA II*, 359 F.3d at 571-572 (internal citations omitted).

[163] Id. at 572.

[164] Id.

> in such a balance, as for example by hewing rather closely to natural monopoly features. The other is to use a looser concept of impairment, with the costs of unbundling brought into the analysis under § 251(d)(2)'s "at a minimum" language. The Commission has chosen the latter, and we cannot fault it for doing so. This is especially true as the statutory structure suggests that "impair" must reach a bit beyond natural monopoly. While for "proprietary" network elements the statute mandates a decision whether they are "necessary," § 251(d)(2)(A), for non-proprietary ones it requires a decision whether their absence would "impair" the requester's provision of telecommunications service, § 251(d)(2)(B). Thus, in principle, there is no statutory offense in the Commission's decision to adopt a standard that treats impairment as a continuous rather than as a dichotomous variable, and potentially reaches beyond natural monopoly, but then to examine the full context before ordering unbundling.[165]

As previously stated, the D.C. Circuit's insistence that "impairment" is limited to, or may only "reach a bit beyond" natural monopoly characteristics, is a judicial creation that finds no support in the language or the structure of the 1996 Act.

The D.C. Circuit did object to one key aspect of the Commission's definition of impairment:

> [I]n at least one important respect the Commission's definition of impairment is vague almost to the point of being empty. The touchstone of the Commission's impairment analysis is whether the enumerated operational and entry barriers "make entry into a market uneconomic." Uneconomic by whom? By *any* CLEC, no matter how inefficient? By an "average" or "representative" CLEC? By the most efficient existing CLEC? By a hypothetical CLEC that used "the most efficient telecommunications technology currently available," the standard that is built into TELRIC? Compare 47 CFR § 51.505(b)(1). We need not resolve the significance of this uncertainty, but we highlight it because we suspect that the issue of whether the standard is too open-ended is likely to arise again.[166]

If the Commission continues to use the "uneconomic" test, and NASUCA submits that it should, the Commission should be prepared to address this objection. NASUCA addresses this issue in Section IV.D., infra.

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[165] Id. (internal citation omitted).

[166] Id. at 572 (internal citations omitted).

The D.C. Circuit also expounded on the issue of what it called "[i]mpairment in markets where state regulation holds rates below historic costs."[167] The D.C. Circuit stated:

> In the name of "universal service," state regulators have commonly employed cross-subsidies, tilting rate ceilings so that revenues from business and urban customers subsidize residential and rural ones. *USTA I*, 290 F.3d at 422. On remand from our decision in *USTA I*, the Commission decided to consider regulated below-cost retail rates as a factor that may "impair" CLECs in competing for mass market customers. See Order P 518. The ILECs object strenuously, and it appears virtually certain that the issue will recur on remand.
>
> The Commission's brief treatment of the issue makes no attempt to connect this "barrier" to entry either with structural features that would make competitive supply wasteful or with any other purposes of the Act (other than, implicitly, the purpose of generating "competition," no matter how synthetic). The Commission rightly says that if prevailing rates are too low to elicit CLEC entry even with the benefit of UNEs, the unbundling mandate will have no consequences. True enough. But it is no defense of a rule to say that it is harmless in those cases where it has no effect at all; that presumably is true even of the most absurd rule.
>
> The interesting case is the one where TELRIC rates are so low that unbundling *does* elicit CLEC entry, enabling CLECs to cut further into ILEC revenues in areas where the ILECs' service is mandated by state law -- and mandated to be offered at artificially low rates funded by ILECs' supracompetitive profits in other areas. If the scheme of the Act is successful, of course, the very premise of these below-cost rate ceilings will be undermined, as those supracompetitive profits will be eroded by Act-induced competition. In competitive markets, an ILEC can't be used as a piñata. The Commission has said nothing to address these obvious implications, or otherwise to locate its treatment of the issue in any purposeful reading of the Act.
>
> We recognize, of course, that the historic accounting costs relied upon by state regulators are, like TELRIC itself, an artificial construct that may not closely track true economic cost. But that is no justification for the Commission's refusal to evaluate the probable consequences of its approach, and to adopt, in the light of those estimations, a policy that it can reasonably say advances the goals of the Act.[168]

The D.C. Circuit's superficial discussion of this issue is responded to at length in Section VI.

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[167] Id. at 573.

[168] Id. (emphasis in original).

With specific regard to mass market switching, the D.C. Circuit found that the Commission's national finding of impairment was based solely on entry barriers related to the need for ILECs to perform "hot cuts" (manual connections) for CLECs if the latter choose to self-provision mass market switches.[169] A big part of the problem for the Commission was that although

> certain sections of the Order suggest that impairment due to hot cut costs might be sufficiently widespread to support a general national impairment finding even in the absence of more "nuanced" determinations to be made by the state commissions, the Commission at other points concludes that a national finding, without the possibility of market-specific exceptions authorized by state commissions, would be inconsistent with *USTA I*. At the very least, these latter passages demonstrate that the Commission's own conclusions do not clearly support a non-provisional national impairment finding for mass market switches, and thus require us to vacate and remand.[170]

The D.C. Circuit also found that the Commission's national finding of impairment for mass market switching due to hot cuts was contradicted by its findings in a number of Commission cases involving RBOC applications under 47 U.S.C. § 271 that the RBOCs were performing hot cuts "in the quantities that competitors demand and at an acceptable level of quality."[171] The Commission's attempts to distinguish these cases was undercut by the fact that, according to the D.C. Circuit, the Commission had also "implicitly conceded that hot cut difficulties could not support an undifferentiated nationwide impairment finding."[172] This concession required reversal of the D.C. Circuit's initial assessment that

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[169] Id. at 569.

[170] Id.

[171] Id. at 570, quoting *Application by SBC Communications, Inc., et al., Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Texas*, Memorandum Opinion and Order, 15 FCC Rcd 18354, 18480 (2000), ¶ 247.

[172] USTA II, 359 F.3d at 570, citing *Triennial Review Order*, ¶¶ 425, 485, 493.

> [t]he record on the matter is mixed, perhaps sufficiently so that the Commission's "provisional" assumption to the contrary might be sustainable as an absolute finding, given the deference we would owe the Commission's predictive judgment and the inevitability of *some* over- and under-inclusiveness in the Commission's unbundling rules.[173]

The D.C. Circuit faulted the Commission for failing to address "more narrowly-tailored alternatives to a blanket requirement that mass market switches be made available as UNEs," which the D.C. Circuit deemed "essential in light of our admonition in *USTA I* that the Commission must balance the costs and benefits of unbundling."[174] The D.C. Circuit therefore vacated the Commission's requirement that mass market switching be unbundled.[175]

The *USTA II* court directed that the decision's mandate would issue no later than the later of May 2, 2004 or the denial of any rehearing or rehearing *en banc*.[176] The D.C. Circuit later denied a Commission request to further stay the mandate, and, on June 14, 2004, Supreme Court Chief Justice Rehnquist denied CLECs' petitions for stay of the D.C. Circuit mandate.[177] The *USTA II* mandate thus issued on June 16, 2004.

## VIII. CONCLUSION

For the reasons set forth herein, the Commission should salvage as much as possible of the *Triennial Review Order*, and should maintain as much as possible of the unbundling regime

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[173] USTA II, 359 F.3d at 570.

[174] Id., citing *USTA I*, 290 F.3d at 429. It should be recalled that this balancing was not a requirement imposed by the Supreme Court in *Iowa Utilities* or *Verizon*.

[175] *USTA II*, 359 F.3d at 571.

[176] Id. at 595.

[177] *United States Telecom Ass'n v. FCC*, D.C. Cir. No. 00-1012 (and consolidated cases) (June 4, 2004) (denying stay of mandate).

that has led to the beginnings of local service competition for residential and small business customers. This would be consistent with the statute and with the Supreme Court's view of the statute, which gives substantial deference to the Commission's decisions.

The Commission should adopt for its own use the principles that it delegated to the states in the *Triennial Review Order* as it makes the unbundling determinations required by *USTA II*. As discussed herein, however, the Commission should review impairment separately for residential and for small business customers, rather than combining them into a single mass market.

Respectfully submitted,

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